normal operations of a competitive market (which include commercial negotiations) can be expected to produce just and reasonable rates for the de-listed network element. Stated differently, market-based rates formed through the workings of a competitive market turn out to be just and reasonable *without* the need for regulatory intervention or rigid pricing guidelines.

Q. HAS THE FCC PROVIDED ANY DIRECTION REGARDING HOW AN ILEC SHOULD TRANSITION FROM TELRIC-BASED RATES TO JUST AND REASONABLE MARKET-BASED RATES FOR DE-LISTED NETWORK ELEMENTS?

A. No. The FCC has only directed ILECs to deploy a 12-18 month transitional pricing plan to mitigate the possible effects of rate shock.[16] Beyond that, the FCC has neither prescribed nor proscribed any particular pricing mechanism for de-listed network elements apart from merely instructing that their rates be just and reasonable. Therefore, a market-based price for a de-listed network element in a competitive setting — in this instance, at the wholesale level — can be expected to emerge either from competitor purchases out of the ILEC's tariffs for comparable services (or elements) or from a commercial negotiation if the bargaining parties can first identify the range of feasible prices. To do the latter may require extensive signaling between the parties, but a negotiation conducted in good faith almost always leads to the range of feasible (or, in the present context, just and reasonable) prices that both parties can accept.

III. ECONOMIC BASIS FOR JUST AND REASONABLE PRICES IN COMPETITIVE MARKETS

Q. PLEASE EXPLAIN HOW COMMERCIAL NEGOTIATIONS IN COMPETITIVE MARKETS LEAD TO JUST AND REASONABLE PRICES.

[16] For most of the seven de-listed network elements, transitional rates are to remain in effect for 12 months. The 18-month duration only applies to de-listed dark fiber loops and transport. See *Triennial Review Remand Order*, ¶¶5, 142-145, 195-198, and 228.

A. In most commercial negotiations (such as of the type relevant for transactions involving de-listed network elements), there are likely to be two parties: the ILEC (as the supplier) and the requesting carrier or CLEC (as the purchaser). Economic theory tells us that the outcome of a bilateral bargaining process depends on the relative costs and benefits to either party as well as on their relative bargaining strengths. The costs and benefits dictate the range of feasible outcomes from which both parties can benefit, while the relative bargaining power of the parties determines how the benefits are shared. Settling on any particular price within that range may imply a different division of benefits between the parties than would a different price within that range but, by definition (and regardless of the division of benefits), *any* price within that range would be efficient and fair or, in other words, just and reasonable. The trick, therefore, is to first identify the *range of feasible prices* (or what economists call the "core"). That range is an integral part of the bilateral bargaining process on which most commercial negotiations are based.

Q. PLEASE EXPLAIN HOW THE BILATERAL BARGAINING PROCESS WORKS.

A. As the term itself suggests, bilateral bargaining occurs, and leads to transactions, between two parties: a buyer and a supplier. Bargaining occurs with respect to terms and conditions of the sale transaction and, specifically, the price. However, it is first necessary to define what the "price" is in this context. The bilateral bargaining process typically involves three prices: (1) the supplier's "reservation" price; (2) the supplier's "asking" (or "offer") price; and (3) the buyer's "maximum willingness-to-pay" price. The reservation price is the lowest price that the supplier will accept. The asking price is the price with which the supplier starts off negotiations. The maximum willingness-to-pay price is the highest price that the buyer is prepared to pay. The supplier's reservation price determines the low end of the range of feasible prices, while the buyer's maximum willingness-to-pay price determines the high end of that range. The range of prices in between defines the range of *feasible* prices. Typically, the supplier's asking price is somewhere within this range. When the bargaining process culminates in an agreement, the actual price at which the two parties settle may or may not be at the original asking price; however, for a successful market-determined outcome, that price must be somewhere within the range of feasible

prices.

In any bilateral bargaining process, each party must first determine what it expects to gain if agreement (here, the supply at wholesale of a de-listed network element) is reached. An economically rational ILEC must evaluate what it may gain or lose by allowing the requesting carrier — most likely a competitor in the retail market — access to its de-listed network element (such as a switch or transport or loop facilities at certain capacities). That is because, by selling de-listed network elements at wholesale, it is likely to trade off serving retail customers (and earning retail revenue) for greater wholesale revenue and more intensive (and, perhaps, more efficient) utilization of its existing network. The ILEC must take into account its revenues from the its wholesale and retail strategies and its opportunity costs of providing a de-listed network element to purchasing competitors in order to determine its reservation price for that network element.[17] This reservation price is generally tied to (but, as I explain below, not necessarily set equal to) its incremental cost of providing the network element.[18]

The competitor seeking to lease that network element must perform a similar cost-benefit analysis. Its "make or buy" decision would contrast its likely cost to lease the de-listed network element from the ILEC with its cost to self-provision that element or obtain it from an alternate source. Since the rival is unlikely to be willing to pay a price that exceeds its cost to self-provision the local switching or obtain it from an alternate source, its maximum willingness-to-pay price would be pegged at that cost.

The range between the competitor's maximum willingness-to-pay (on the upper end) and the ILEC's reservation price (on the lower end) represents the range of feasible prices for the de-listed network element from a bilateral bargaining process. If that range exists,[19]

[17] The higher margin from selling retail services means that the ILEC would rather sell the retail service to the end user than sell the UNE to a CLEC that would then serve the end user. However, the ILEC would rather sell its UNEs at wholesale than sell nothing at all and, for de-listed network elements, CLECs have economically viable alternatives to the ILEC's network elements.

[18] The efficient price would be the sum of the profit margin on its retail service and the incremental cost of the de-listed network element.

[19] I explain below the circumstances in which that range may not exist.

then the parties would start the bargaining process off by focusing first on the ILEC's asking price. Any agreement struck on a price somewhere within that range (whether at or away from the asking price) would be mutually beneficial (because the ILEC would receive no less than its reservation price and the competitor would pay no more than its maximum willingness-to-pay). Exactly at which price within that range agreement is reached would depend on other aspects of the bargaining process (the parties' relative strengths, skills, information, etc.), but the consequent division of benefits would be less important than the fact that, in a competitive setting, a market-based price would emerge that both parties could find just and reasonable.[20]

Q. DOES THIS NOTION OF SELECTING A JUST AND REASONABLE PRICE FROM WITHIN A *RANGE* OF FEASIBLE PRICES HAVE ANY PRECEDENT IN TELECOMMUNICATIONS?

A. Yes. The best example, as I noted earlier, is of the *CALLS Order* which described any rate for switched access service as being just and reasonable if it fell within the range of economic costs for switched access. It is important to understand that the range of feasible prices from which just and reasonable prices for de-listed network elements can emerge should *not* be formed arbitrarily or through regulatory fiat. In effectively competitive markets, when non-impairment has been established, that range of feasible prices can emerge not by regulatory means but through the revelation by bargaining parties of the reservation (low-end) price and the maximum-willingness-to-pay (upper-end) price. These two ends of the feasible price range are based solely on the objective reality of the marketplace and the costs that the two bargaining parties face; they have nothing to do with regulatory pricing formulas associated with TELRIC or the older standard of embedded cost.

In a competitive market, the purchaser of a de-listed network element has at least three choices: (1) purchase that element from an ILEC at a market (non-TELRIC-based) rate; (2)

[20] A similar analysis that leads to "fair and efficient" prices (analogous to just and reasonable prices) can be found in William J. Baumol, *Superfairness: Applications and Theory*, Cambridge, MA: The MIT Press, 1986.

purchase that element from an alternate source that may be another CLEC or supplier of network facilities; or (3) acquire or supply that element itself. A rational CLEC faced with these choices will seek to lower its maximum willingness-to-pay by determining first which of these three sources of the requisite network element requires the least expenditure (including opportunity costs, if any). If it believes that self-supply is likely to be cheaper than purchasing from an ILEC or an alternate source, then that CLEC will withdraw from commercial negotiations with potential suppliers unless one (or more) supplier becomes willing to accept a price below the CLEC's cost to self-supply.

At the other end of the range of feasible prices, when the potential supplier (whether ILEC or an alternate source) signals its reservation price, the purchasing CLEC must again evaluate whether it is better off negotiating the lowest possible price with that supplier or resorting to self-supply. It is important to note that, because of an ILEC's extensive need to recover fixed and shared and common cost as well as various regulation-directed franchise obligations (such as universal service), the ILEC's reservation and asking prices may well exceed its incremental cost to provide the de-listed network element. That is, economically efficient markups in prices to recover the non-incremental costs can typically be expected — indeed are necessary — even in a competitive market. Moreover, because the ILEC in such a market must have the freedom to seek out the highest possible price for its resource (for reasons explained previously), the incremental cost of the de-listed network element may have little to do with the market-based price on which the two bargaining parties settle ultimately.

Q. SHOULD THE LOW END OF THE RANGE OF FEASIBLE PRICES BE THE ILEC'S TELRIC TO PROVIDE A (NOW DE-LISTED) NETWORK ELEMENT AS A UNE AND, IF SO, SHOULD THE ILEC BE OBLIGED TO OFFER THAT ELEMENT AT A TELRIC-BASED RATE?

A. No. The low end of the range of feasible prices cannot *by design* be the ILEC's TELRIC to provide the de-listed network element. In a competitive market, the ILEC should not be enjoined to fix a pre-determined price floor, particularly one based on a regulatory pricing rule. If just and reasonable prices resemble those that would emerge in a competitive

market, the ILEC's reservation price cannot be determined by any measure of its costs alone. In addition, the FCC has specifically ruled out any obligation of the ILEC to set just and reasonable prices for de-listed network elements on the basis of TELRIC. To peg those just and reasonable prices to a specific regulatory pricing formula such as TELRIC would be to make a mockery of the principles that guide price determination in competitive markets. Also, where any actual TELRIC-based rate falls *outside* the range of feasible prices, forcing the ILEC to accept that rate would only subvert the "just and reasonable" standard itself and the commercial negotiation process that is supposed to lead to it. The bottom line is simple: in an effectively competitive market, and in the absence of any impairment, the market — not regulation or regulatory formulas — must have the opportunity to discover just and reasonable prices.

Q. WHY WOULDN'T IT ALWAYS BE IN THE BEST INTEREST OF CONSUMERS AND THE ILEC'S COMPETITORS FOR THE DE-LISTED NETWORK ELEMENT'S PRICE TO BE SET AT THE *LOW* END OF THE RANGE OF FEASIBLE PRICES?

A. There are several objections to the basic premise of this question. First, the only entities involved in "setting" the market-based price of a de-listed network element in a competitive market should be the two bargaining parties. In other words, if they are to succeed in producing true market-based rates, commercial negotiations cannot be conducted under an overhang of the ready availability of regulatory or other outside intervention. Seeking recourse to an external mediating or arbitrating authority should only be an option when the negotiating parties are hopelessly deadlocked and *mutually* consent to submitting to such intervention. By definition, a non-impaired purchasing competitor has other options for acquiring the de-listed network element (including self-supply) and, therefore, cannot be so locked into an impasse in its negotiations that resorting to outside intervention is the only course of action left to it.

Second, as I explained above, the most realistic low-end or reservation price for the ILEC is *not* its underlying incremental cost for the de-listed network element but, rather, a market-determined markup over those incremental costs. In competitive markets, firms

with large fixed and shared and common costs to recover have to resort to such markups to recover all their costs. They do so, however, by testing the strength of market demand for their products, *i.e.*, by determining the levels of marked-up prices that their consumers are willing to pay. This is akin to a form of "bargaining" between the firms and the collective group of their customers. No outside intervention occurs, and firms remain free to determine just how much they should mark up (or down) their prices. All the while, consumers remain free to seek alternative sources of supply, much as a non-impaired purchasing competitor would when negotiating with an ILEC for a de-listed network element.

Third, the range of feasible prices is a legitimate range for both the ILEC and the purchasing competitor. The ILEC signals that it is willing to accept any price that is at or above the level that meets its own need to recover its fixed and shared and common costs apart from its incremental cost. At the same time, the purchasing competitor signals that it is willing to pay no more than its maximum willingness-to-pay price. By definition, that means that the competitor is ready to pay up to the high end of the range of feasible prices. So, any presumption that the competitor should only be asked to pay the price at the low end of the range is simply wrong. A non-impaired competitor has recourse to competitively available alternatives and the lowest price it has to pay for any such alternative sets the ceiling on what it would be willing to pay to acquire the de-listed network element from the ILEC. Failure to recognize this fact — and, worse still, compelling the ILEC through regulatory means to sell the de-listed network element at the low end of the range of feasible prices — can only make a mockery of the FCC's painstakingly constructed impairment test and reasons for de-listing UNEs.

Finally, the argument that consumers are better off the lower is the price at which purchasing competitors can acquire de-listed network elements from ILECs has a certain surface appeal but masks several deeper issues that informed policymakers must never overlook.

Q. PLEASE EXPLAIN THOSE ISSUES.

A. The unfettered operation of a competitive market produces several desirable outcomes, of

which the most important is the generation of efficient price signals to guide consumption, investment, and, in particular, the "make or buy" decision of competing suppliers. This happens because, in such a market, scarce — and freely mobile — resources seek out their highest-paying uses and resource users find ways to use those resources most economically. Thus, when prices are formed through the normal operations of a competitive market, the costs and willingnesses-to-pay of a multitude of market participants get factored into those prices.[21] Commercial negotiations in multiple bargaining situations are an integral part of that process, enabling both buyers and sellers to seek out the best possible terms and conditions. Because of non-impairment, CLECs and other competitors have several options (including self-supply) for obtaining the network elements they need, and ILECs have the freedom — as they should in a competitive market — to locate buyers that are able to at least pay their asking prices.[22] In these circumstances, the price at which an agreement is concluded may or may not end up at the low end of the range of feasible prices. However, whatever the outcome, it is the market that provides the mechanism for the discovery of that equilibrium price. Regulators or regulatory intervention should have nothing to do with it.

Any outside interference with the normal operations of a competitive market and the discovery of equilibrium prices carries the danger that efficient price signals will fail to be generated. If that happens, the result can be both inefficient levels of consumption and investment and distortions in the "make or buy" decisions. In time, such outcomes can subvert the competitive process itself and destroy incentives of both customers (seeking to maximize their personal utilities and satisfy their needs) and suppliers (seeking to maximize returns or other objectives). For example, if the price of a de-listed network element is forced (through some external mechanism) to be set below the equilibrium level

[21] These include, among other things, the cost of self-supply, prices of competitive alternatives (or feasible intermodal substitutes), and opportunity costs to the ILECs.

[22] Because both CLECs/purchasing competitors and ILECs have feasible alternatives in that market, there is absolutely nothing wrong with either the ILEC (the resource owner) seeking the highest possible price for the resource *or* the CLEC (the resource purchaser) seeking the lowest possible price for it.

that would prevail in a competitive market, it would (1) encourage excessive consumption or inefficient use of the element, (2) depress the incentive of the supplier to offer more of the element, and, most importantly, (3) distort the "make or buy" decision of purchasing competitors in the direction of buying. The last of these effects can, in time, produce serious disincentives for competitors to invest in their own facilities and curtail — perhaps irreversibly — the market's ability to generate new and varied services, innovation, and other benefits for consumers. In the absence of vigorous and sustained facilities-based competition in a dynamically competitive market, consumers would ultimately be the losers. Any short-term gain to consumers from forcing prices to the low end of the feasible range would be pyrrhic at best.[23]

The illusion that low UNE prices give rise to more unbundling and more local exchange competition was addressed some years ago by Justice Breyer:

> Nor are any added costs imposed by more extensive unbundling requirements necessarily offset by the added potential for competition. Increased sharing by itself does not automatically mean increased competition. It is in the unshared, not in the shared, portions of the enterprise that meaningful competition would likely emerge. Rules that force firms to share every resource or element of a business would create, not competition, but pervasive regulation, for the regulators, not the marketplace, would set the relevant terms.[24]

Furthermore, it is not a given that the lower prices negotiated (or obtained through compulsion from an external authority) by a purchasing competitor will automatically be passed on to consumers in the form of lower retail prices. Competitors operate at varying levels of efficiency. Consumers (and society, in general) are better off only if those

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[23] The FCC has recognized the folly in artificially lowering prices to consumers when efficient prices need to be higher. The consequent disincentive to investment in facilities by both ILECs and CLECs, and the eventual dissipation of facilities-based competition, do more harm in the long run to society at large than the purely ephemeral benefits that "low" prices can produce. This concern for the health of long-term facilities-based competition comes across in several places. See *Triennial Review Order*, ¶330, ¶404, and ¶682; *Triennial Review Remand Order*, ¶36 and ¶¶218-221; FCC, In the Matter of Review of the Commission's Rules Regarding the Pricing of Unbundled Network Elements and the Resale of Services by Incumbent Local Exchange Carriers, WC Docket No. 03-173, Notice of Proposed Rulemaking, released September 15, 2003, ¶3 and ¶83, and the Separate Statement of Chairman Michael K. Powell. See also fn. 22, *infra*.

[24] AT&T v. Iowa Utils. Bd., 119 S. Ct. at 102 (1999). Justice Breyer concurring in part and dissenting in part.

competitors are at least as efficient as the ILEC, but not so if they are less efficient. A competitive marketplace acts like a sorting agency in which different suppliers compete on the basis of their relative efficiencies. Over time, the least efficient competitors fail to survive and exit the market. In a competitive and dynamically efficient market, that is exactly how it should be, and no special dispensation (by whatever means) should be extended to competitors that cannot at least match the ILEC's efficiency (given non-impairment and holding all other things equal).

Q. PLEASE EXPLAIN WHY THAT "SPECIAL DISPENSATION" SHOULD NOT BE EXTENDED TO COMPETITORS.

A. When an ILEC attempts to set a market-based price for a de-listed network element, it discovers through the commercial negotiations process which (and how many) competitors are willing to pay the asking price and which (and how many) are not. If that asking price is "too" high (such as when it exceeds the maximum willingness-to-pay price of *any* competitor), it will not attract any buyer for its de-listed network element. Rather, being non-impaired, competitors seeking the de-listed network element will seek alternate sources (including self-supply). The asking price at which it will attract equally or more efficient competitors is that at which it would "sell" itself the de-listed network element.

Obviously, less efficient competitors would seek lower asking prices from the ILEC, perhaps even at levels below the ILEC's reservation price. There is nothing wrong with competitors attempting to pay less than the ILEC's asking price, as long as that price is within the range of feasible prices. How well it succeeds at that endeavor will depend on the negotiating competitor's relative efficiency, bargaining skill, access to competitive alternatives, and other factors.

Forcing the ILEC, however, to lower its asking price below its reservation price, or to charge a price no higher than its incremental cost (TELRIC or otherwise), would be, as I noted above, a mistake for a number of reasons. First, it would preserve a relatively inefficient competitor that cannot be profitable unless it is able to acquire, through some means, the de-listed network element at an inefficiently low price. In fact, this would be little different from the UNE regime where only a TELRIC-based price would suffice.

Second, propping up a non-impaired but inefficient competitor in this manner would hurt, rather than benefit, consumers who are entitled to service at the lowest possible cost. Third, the ILEC would then have little or no incentive to offer or invest in the de-listed network element since it is no longer under a regulatory compulsion (under Sections 251 and 252 of the 1996 Act) to make it available to requesting carriers. Finally, for reasons already noted, the purchasing competitor too would have little or no incentive to earnestly seek out alternative sources of supply (including self-provisioning and intermodal alternatives).[25]

Q. IS IT POSSIBLE FOR THE BILATERAL BARGAINING TO FAIL TO PRODUCE A JUST AND REASONABLE PRICE?

A. Yes. The bargaining process could fail to produce a mutually acceptable agreement (on a just and reasonable price) under two important circumstances. First, if the range of feasible prices does not exist, such as, for example, when the competitor's maximum willingness-to-pay is actually *below* the ILEC's reservation price, no agreement may be reached. This would very likely be the case if, with or without the aid of an external authority, a competitor were to insist on not paying any price above the ILEC's incremental cost or, in particular, the TELRIC-based rate from the UNE regime. Second, when the information possessed by the two parties in the bargaining process is seriously *asymmetric* (*i.e.*, one party knows much more about the other's options and can, hence, act strategically, while the other party cannot), no agreement may be reached. These two conditions may even be

[25] The FCC has already noted that persisting with the UNE regime for the mass-market local switching (and, hence, supporting low-cost availability of UNE-P) has had the perverse outcome of CLECs making widespread use of UNE-P to serve its mass-market customers despite having deployed the more modern, flexible, and scalable switches in significant numbers. See *Triennial Review Remand Order*, ¶220 and accompanying footnotes. We note that the FCC has specifically stated that the "availability of UNE-P also has hindered the ability of competitors to use intermodal facilities to compete for local telephone customers." *Id.* This is important because the determination of non-impairment must take into account the intermodal alternatives that competitors can feasibly acquire. Therefore, competitors may seek such alternatives from both non-ILEC wireline *and* intermodal sources.

related.[26]

For the bilateral bargaining process (or commercial negotiation) to be successful, the bargaining must be held in good faith and without efforts by either party to "game" the process, i.e., pursue a strategic advantage based on some strength or material information possessed by one party but not the other. It is important, therefore, that the two parties negotiate in good faith by signaling their true maximum willingness-to-pay or reservation price to each other. Absent that, it may be very difficult (if not impossible) to even identify the range of feasible prices — the starting point for discovering the just and reasonable price.

Q. IS IT IN THE BEST INTERESTS OF BOTH PARTIES TO NEGOTIATE IN GOOD FAITH AND NOT ATTEMPT TO GAME THE PROCESS?

A. Yes, this is an instance where "cooperative" behavior by both parties can actually be mutually beneficial and, in the process, beneficial to retail customers. Game theory tells us that non-cooperative bargaining — whether by one of the two parties or both — is unlikely in this context to produce a higher payoff for either party. Non-cooperative bargaining would take the form of false signaling (of the willingness-to-pay or the reservation price), stalling, refusals to deal, attempts to impose third-party intervention, *etc.* In contrast, cooperative bargaining would call for either party to produce all the information relevant to the identification of the range of feasible prices and then the subsequent effort to identify the actual price point within it that would be acceptable to both parties.[27] Given the present context, non-cooperative bargaining has a far lower probability than cooperative bargaining of producing a just and reasonable price at which transactions for the de-listed network element can be conducted.

Non-cooperative strategic behavior by either party can also have other costs that affect the parties themselves and, as well, consumers and society at large. Every day that an

[26] See Jean Tirole, *The Theory of Industrial Organization*, Cambridge, MA: MIT Press, 1988, p. 24.

[27] For example, we understand that BellSouth's tariffed prices for for de-listed network elements are publicly available.

agreement eludes the two parties, costs associated with the delay and competitive positioning can fall on both parties: on the competitor (as an additional cost to do business that makes its operations less efficient) and on the ILEC (by preventing it from reaching a more efficient state of network utilization). There can also be non-trivial transactions costs associated with mediation/arbitration and litigation, in general.

Both parties must perceive that it is in their mutual interest to discover the mutually acceptable price for a de-listed network element through a cooperative bargaining process, and to recognize that price as just and reasonable within the context of the competitive market in which they both operate. Failure to do so would not only harm those parties but also prove detrimental to consumers and society at large. In fact, by avoiding non-cooperative posturing and protracted mediation or arbitration (sometimes seen by one or the other party as a way to secure a strategic advantage for itself), the two parties can ensure that unnecessary and wasteful social costs are also avoided.

Q. IF IT REMAINS POSSIBLE FOR THE BILATERAL BARGAINING PROCESS TO FAIL TO PRODUCE A JUST AND REASONABLE RATE FOR A DE-LISTED NETWORK ELEMENT, SHOULD THAT RATE BE SET BY REGULATORY MEANS?

A. No. The purpose of regulation is to emulate the workings of a competitive market when, for one reason or another, competitive conditions fail to exist in a market on a sustained basis. The very fact that the FCC has de-listed certain network elements (by concluding that requesting carriers are no longer impaired without their availability as UNEs) means that competitive markets exist for those network elements. This eliminates the basic economic rationale for regulatory intervention to ensure that rates for those network elements satisfy the "just and reasonable" standard. In any event, only the FCC has the authority to investigate whether that standard is being met and to take corrective action if it is not.

Ex ante regulatory intervention (such as at the state level) for setting prices for de-listed network elements should be avoided for another reason. When competitive conditions prevail and, most notably, competitors have feasible alternatives to ILEC-supplied network

elements (including intermodal alternatives), unneeded regulation can become an instrument of "regulatory capture." This happens when one party to a bilateral negotiation tries to manipulate regulation (and regulators) to secure favorable outcomes that it cannot achieve on its own. That is, that party relies on the coercive power of regulation to secure its ends rather than on good faith negotiations. Given that ILECs are regulated and their competitors are not, it is not hard to imagine that this strategic use of regulation to "find" just and reasonable prices is far more likely to be exercised by competitors than by ILECs. Absent concrete evidence that competitive markets are being hindered from discovering just and reasonable prices for de-listed network elements, state regulators must resist any and every effort at such manipulation and avoid intervening on behalf of either party, even inadvertently. As in other competitive markets, courts of law remain available to both parties to resolve commercial disputes.

Q. WHAT SAFEGUARDS EXIST TO ENSURE THAT COMMERCIAL NEGOTIATIONS PRODUCE PRICES FOR DE-LISTED NETWORK ELEMENTS THAT SATISFY THE "JUST AND REASONABLE" STANDARD?

A. Before identifying the safeguards, it is first important to note that bilateral negotiations within competitive markets *can* produce diverse outcomes, and to remind ourselves that the "just and reasonable" standard is associated with outcomes, not with a unique price or pricing formula. Within this context, however, there are still reasons to be assured that competitive markets can have a tempering effect on separate bilateral negotiations. In such markets, prices (even those negotiated bilaterally) signal underlying costs and efficiencies. Because prices of de-listed network elements are publicly available, competitors with comparable costs and efficiencies are likely to end up negotiating similar prices, and differences in prices are likely only to arise for purchasing carriers that are *not* similarly situated. When competitive alternatives (including the option of self-supply) are available, significant variations in negotiated prices across similarly-situated purchasing carriers

become improbable.[28]

Moreover, as the FCC has explicitly stated, investigations are likely to be triggered if such unwarranted variations do occur.[29] That is, the FCC already has in place some safeguards that preserve the integrity of negotiated prices in competitive markets and prevent the kinds of pricing outcomes that could warrant regulatory intervention. For example, one such safeguard is stated as follows.

> We note ... that for a given purchasing carrier, a B[ell] O[perating] C[ompany] might satisfy this standard by demonstrating that the rate for a section 271 network element is at or below the rate at which the BOC offers comparable functions to similarly situated purchasing carriers under its interstate access tariff, to the extent such analogues exist.[30]

This safeguard is inherent, for example, in an ILEC's interstate special access tariffs. The FCC clearly believes that the ILEC's tariffed special access rates can serve as a check on the market-based prices for de-listed network elements that emerge from commercial negotiations. Consider the FCC's expression of this belief for de-listed dedicated transport.

> Because we remove significant dedicated transport unbundling obligations, ... we find it prudent to establish a plan to facilitate the transition from UNEs to alternative transport options, including special access services offered by the incumbent LECs. Specifically, for DS1 and DS3 dedicated transport we adopt a twelve-month plan for competing carriers to transition to alternative facilities or arrangements, including self-provided facilities, alternative facilities offered by

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[28] As long as the possibility of arbitrage (such as through resale) exists, those variations will remain unlikely. However, even if purchases are made through contracts that reduce the opportunity for purchasing carriers to switch at will (e.g., to resellers that offer better deals), an ILEC would only put itself at a disadvantage *in the long run* if it tried to use term contracts to "lock up" wholesale customers at exploitative prices. Quite the contrary, the fact that term and volume contracts abound, such as for tariffed special access services, indicates that the strategic use of contracts to lock up wholesale customers in that manner is not an attractive option for ILECs.

[29] This is where the "just and reasonable" standard intersects with the non-discrimination requirement. The confluence of the two, without the need for regulatory intervention, is a hallmark of competitive markets. See the *Triennial Review Order*, ¶644, for the FCC's criteria for triggering investigations even in competitive markets.

[30] *Id.*

other carriers, or special access services offered by the incumbent LEC.[31]

In a similar vein, the FCC has expressed confidence in the availability of competitive alternatives to ensure that ILECs' market-based rates for de-listed local switching remain just and reasonable.

> Based on the evidence of deployment and use of circuit switches, packet switches, and softswitches, and changes in incumbent LEC hot cut processes, we determine not only that competitive LECs are not impaired in the deployment of switches, but that it is feasible for competitive LECs to use competitively deployed switches to serve mass market customers throughout the nation.[32]

> Competitive LECs are able to serve larger geographic areas because they can deploy higher capacity switches and use dedicated transport in combination with those switches to serve customers throughout a wider geographic area, beyond the particular wire center where the switch is located. Thus, even though competitive circuit switches are not deployed as ubiquitously as incumbent LEC circuit switches, this does not prove that competitive LECs are impaired in wire centers where there currently are no competitive switches, as competitive LECs can and do serve such areas using switches located in other areas. In addition, pursuant to the "reasonably efficient competitor" standard discussed above, we evaluate impairment based on the technology a reasonably efficient competitive LEC would deploy. Competitive LECs can rely on newer, more efficient technology than incumbent LECs (whose networks have been deployed over decades), such as packet switches. Further, the ability of competitive circuit switches to serve wider geographic regions reduces the direct, fixed cost of purchasing circuit switching capability and allows competitive carriers to create their own switching efficiencies.[33]

Collectively, these safeguards are sufficient to ensure that commercial negotiations conducted in good faith between ILECs and purchasing competitors will produce only just and reasonable prices for de-listed network elements. Regulatory intervention, particularly of the ex ante variety at the state level, can only be unnecessary, counter-productive, and susceptible to regulatory capture.

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[31] *Triennial Review Remand Order*, ¶142. Footnote omitted from cited text. The FCC expressed a similar belief about de-listed high capacity loops. *Id.*, ¶195.

[32] *Id.*, ¶204.

[33] *Id.*, ¶207. Footnotes omitted from cited text.

IV. POLICY IMPLICATIONS FOR THE COMMISSION

Q. IN LIGHT OF YOUR DISCUSSION OF THE ISSUES, WHAT SHOULD THE COMMISSION CONCLUDE IN THIS PROCEEDING?

A. I understand that BellSouth has signed 184 commercial agreements for either mass-market local switching or a DS0 wholesale platform throughout its region. Of these, 172 apply in Georgia. Also, BellSouth has interstate and intrastate tariffs for both high-capacity loops and transport. I urge the Commission to follow the FCC's directive regarding what constitutes just and reasonable rates for the de-listed network elements and adopt the rates that are formed according to that directive for the Section 271 rates at issue in this proceeding.[34]

Q. WHAT IS THE BASIS FOR YOUR OPINION AS TO THE POLICY THAT THE COMMISSION SHOULD ADOPT?

A. Sound economic practice and the FCC's interpretation of the "just and reasonable" standard in the context of de-listed network elements imply that the Commission ought to adopt the rates in the commercial agreements and applicable tariffs. This conclusion is bolstered by previous actions of this Commission. First, as I understand it, the Commission has already approved over 60 BellSouth commercial agreements. While BellSouth disagrees with the Commission's right to assert such jurisdiction, and while the Commission itself vacated its own order requiring the approval of commercial agreements, the fact remains that the Commission had already determined that the rates contained in those agreements were just and reasonable. Second, with respect to high-capacity loops and transport, BellSouth's commercial offerings consist of the tariffed offerings the Commission has already approved. Third, any resale rates have already been approved by this Commission. By virtue of its own decisions, it appears to me that the Commission has made the determinations necessary to set just and reasonable rates in this proceeding.

[34] BellSouth witness Thomas G. Williams addresses line sharing rates.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes.

BY MS. MAYS:

Q Dr. Taylor, did you also cause to be filed one exhibit with your testimony?

A Yes.

Q Do you have any changes or corrections to that exhibit?

A No.

MS. MAYS: Mr. Chairman, if we could have the exhibit identified as BellSouth's Hearing Exhibit 1.

CHAIRMAN WISE: So marked.

(The document referred to was marked for identification as BellSouth Exhibit Number 1.)

BY MS. MAYS:

Q Dr. Taylor, have you prepared a summary of your testimony?

A Yes, I have.

Q Could you give it now, please?

A Yes, thank you. Good afternoon.

The purpose of my testimony is to describe from the perspective of a telecommunications economist, what this just and reasonable pricing standard actually means when it's applied to delisted network elements. Now, remember that these network elements are the ones that are determined to have been sufficiently available from other suppliers in

the market, that a lack of access to BellSouth's elements doesn't constitute a barrier to entry that would make CLEC entry into the retail local exchange market uneconomic. That's the animal we're talking about.

I don't address at all the Georgia Public Service Commission's authority to set those rates in this case, talk to someone else for that.

First, the just and reasonable standard is not a single cost-based standard, either in the eyes of the FCC, of economics or state regulatory history. Ever since the Hope decision, the Supreme Court decision, the just and reasonable standard for regulated prices has focused on the overall outcome of the prices, not simply the process by which or the methodology by which those prices were created. Thus, for example, FCC interstate switched access rates were set historically at many multiples of any measures of cost but were nonetheless just and reasonable because they helped cover -- recover the total cost of the firm.

The FCC's regulated prices, their own regulated prices have evolved over time while still remaining in their view just and reasonable. They go from Part 69 fully distributed historical costs, where access charges began, to a price cap system that was initially based on such fully distributed costs to incremental forward looking costs with various markups. The TELRIC standard, the reciprocal

compensation standard, mixtures of these concepts, the pole attachment mechanism. And finally, we find them at market-based rates. And for that you can see the special access phase two rates and the FCC's statements about just and reasonable rates for delisted UNEs.

Now, even when these rates were explicitly cost-based, the word based was always in there. And that's a hole you can drive a truck through. These rates were not set equal to cost. Rather, these rates included markups for shared, fixed and common costs. And recently at the FCC, just and reasonable prices have moved from these explicit ties to some measure of cost to market-oriented prices. For example, the call switched access rates were set following a formula, the intention of which was, according to the FCC, to get a better approximation to market rates than you would get with a continuation of the price cap formula.

And secondly, under phase two special pricing flexibility the FCC explicitly said that the availability of alternative providers will ensure that rates are just and reasonable. It has no reference to cost -- the availability of alternative providers. So as a result in the current case we can't simply compare proposed prices with cost and conclude that prices above some cost standard aren't just and reasonable by the FCC standard.

Prices in competitive markets are frequently many

multiples of incremental cost, particularly where, as in telecommunications, firms have fixed cost that are shared across products or services. Compare the markups for bread and milk at the supermarket with the markup on imported marmalade, they're not the same. It is not cost-based in the sense of dictated by price. Prices for particular services in regulated markets have been deemed just and reasonable, not because they approximate the cost of the service but, together with other prices, the aggregate cost to the consumer of the telecommunication service is just and reasonable. Compare the markups for toll service, for switched access service, for vertical services with the markups for basic residential local exchange service.

Now, the main goal for an economist and I think for a regulator too, is to determine what prices would be if we all agreed that the market were competitive. If we could do that, we could go home. That's the object. The goal of the game is to set rates at that level and cost-based rates historically were used as perhaps the best attempt to approximate market prices where competition was absent. As I said before, cost-based doesn't mean equal to cost. We've always had the problem of marking up cost, of marking up prices above cost in order that the firm can recover its total cost.

But I think there is general agreement that

whatever role costs have in calculating market prices they must be forward looking incremental costs, that embedded and historical costs are not the costs that are used.

Now, what does the FCC standard say about this? It's fairly explicit as I read it about the standard for delisted unbundled network elements. The TRO indicates that the FCC's standard for just and reasonable prices in this case, in these markets for delisted UNEs under Section 271 contemplates a market-based standard. Paragraphs 651 and 652 of the TRO say that market prices should be permitted to prevail for such network elements rather than requiring forward looking prices. And in 652, the conclusion that the marketplace rather than our TELRIC methodology should determine the prices for delisted network elements under 271.

And then paragraph 664 gives two benchmarks that we're all familiar with, for just and reasonable prices. That is, look at negotiated commercial agreements, what are those? Those are market prices. Then, also look at tariffed regulated special access prices.

The FCC's standard for what are just and reasonable rates which to apply to these 271 requirements is fairly clear I think and is congruent to what an economist would say. I think sound economic practice, the FCC's interpretation of just and reasonable implies that this

Commission ought to adopt as a benchmark rates in the commercial agreements or the applicable tariffs that have been found to be just and reasonable. As I understand it, this Commission has already approved over 60 BellSouth's commercial agreements under Section 252. And has already held that -- that those rates were just and reasonable.

Finally, with respect to high capacity loops and transport, BellSouth's commercial offering consists of the tariffed offering that the Commission has already approved. It seems like from its own decision, that this Commission has made the necessary determination to set just and reasonable rates in this proceeding.

And that concludes my summary.

MS. MAYS: Thank you, Dr. Taylor. The witness is available for cross.

COMMISSIONER BAKER: Dr. Taylor, you said what your idea of a just and reasonable rate is in a competitive market, can you give us idea, is there a standard by which to use -- to evaluate a rate in a competitive market to determine if it isn't just and reasonable?

THE WITNESS: My own view is probably not. That is if you look hard at the market and you just decide that there are competitive forces at work and we're not -- not arguing about that, if we agree that it's competitive, then speaking as an economist, whatever rates for individual

services come from that, I believe are just and reasonable.

COMMISSIONER BAKER: Okay, and what are those competitive market forces that we should look at to make a determination that we have a competitive market and let's put it in the context of a telecommunication market.

THE WITNESS: Sure. Well, for retail markets, we're familiar with those. I think you finished a detariffing decision or something like that in Georgia last year. Where you looked at the elements of competition for retail services and determined, I think -- I wasn't involved -- that in your view those retail markets were effectively competitive so that BellSouth was unable to exert market power, was unable to price its services consistently above a competitive market level. So, what you looked at then I presume were things like who was providing service, what are the barriers to entry, what are the consequences of relaxing regulations in -- in that market and determined that was -- that was sufficiently competitive.

For the wholesale market in question here, I don't think you made that finding in any technical sense. The FCC tho did say that it believes that just and reasonable in this very wholesale market for 271 undelisted UNEs should be market-based. So, to me that implies that they don't know exactly that the market is perfectly competitive or sufficiently competitive in Georgia for switching, for